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Tax Reform Unraveling

Michael J. Graetz

The Tax Reform Act of 1986 was widely heralded as the most significant change in our nation's tax law since the income tax was extended to the masses during World War II. It was the crowning domestic policy achievement of President Ronald Reagan, who proclaimed it "the best antipoverity measure, the best pro-family measure and the best job-creation measure ever to come out of the Congress of the United States" (Reagan, 1986). This journal published a symposium on the Tax Reform Act in its first issue. The law's rate reductions and base broadening reforms were mimicked throughout the countries belonging to the OECD (Sandford, 1993; Owens, 2005). Even at the time, however, reading the paeans to this legislation was like watching a Tennessee Williams play: something was terribly wrong, but nobody was talking about it. Two decades later, the changes wrought by the 1986 act have proven neither revolutionary nor stable.

As a political matter, it was necessary for the 1986 Tax Reform Act to be approximately revenue neutral and roughly distributionally neutral to achieve the bipartisan majorities necessary for its enactment. Thus, the legislation can be broadly viewed as a rearrangement of the tax code, in which marginal tax rates were reduced and the tax base was broadened by limiting or eliminating various loopholes, deductions, and exemptions. The 1986 act did enhance both the equity and efficiency of the income tax, but it was far from the purist cleansing of the tax code that some of its more ardent admirers implied.

The 1986 act substantially increased the permissible amount of tax-free income, removing about six million low-income people from the income tax rolls; lowered and flattened income tax rates; shut down mass-marketed tax shelters for high-income individuals and curtailed their ability to shift income to lower-income

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family members subject to lower marginal tax rates; and taxed capital gains at the same rates as ordinary income (Musgrave, 1987). An increase in corporate tax revenues was used to finance an overall reduction in individual tax revenues, although the corporate marginal tax rate was also reduced (from 46 to 34 percent). The increase in corporate tax revenues came largely from repealing tax benefits for new investments in real estate and equipment. In combination, these changes reduced the tax burden on service companies while increasing it for capital-intensive industries, including manufacturing firms and real estate, a change which made the income tax burden considerably more neutral across industries.

Tax reform that is both revenue and distributionally neutral is unlikely to have massive effects on the economy. The Tax Reform Act neither spurred American productivity, as some of its admirers hoped, nor destroyed it, as many of its detractors had warned. Slemrod (1990) estimated that the 1986 act may have spurred as much as a 1 percent increase in hours worked—a genuine benefit, but hardly a new American revolution. In addition, the act ultimately fell short of creating a substantially fairer income tax, because it left in place many avenues for tax-favored treatment. Tax-exempt fringe benefits such as health insurance, pensions, and others were hardly touched. Complex new rules limited personal interest deductions to homeowners. Many provisions offering incentives for specific investments such as tax-deferred annuities and tax-exempt state and local bonds were continued, and new ones were added. Families were permitted a tax reduction when a child turned 14, no doubt to offset the additional burdens of having an adolescent in the household. Hundreds of scatter-shot “transition” rules were enacted to give special tax breaks to particular companies or individuals. For instance, donors purchasing valuable football or basketball tickets from the University of Texas or Louisiana State University were allowed to count a substantial portion of the tickets’ total cost as a charitable deduction. This rule was so envied by other football and basketball powerhouses that in 1988 Congress extended the generosity to donors purchasing athletic tickets from other colleges and universities.

Compromise is often the handmaiden of tax complexity, and the 1986 legislation was forged out of hundreds of political compromises. Rather than eliminating provisions of dubious merit, Congress settled for reducing their benefits or restricting their use. Examples abound: the new tax law contained rules distinguishing at least 17 different categories of interest expenses; the 1986 rules for international investments were stupefying in their complexity; and the alternative minimum tax provisions (originally intended to make sure that those with high incomes all pay at least some minimum level of tax) required three different ways of calculating income, each with its own rate schedule.

This 1986 tax reform legislation was an uneasy marriage of two contrary ideological and political camps. Conventional Democratic tax reformers were principally interested in improving tax equity by eliminating tax preferences and treating all income alike regardless of its source. On the other side, Republican supply-siders and deregulators were principally interested in lowering tax rates.

Support for tax reform was bipartisan, but tepid. The 1986 act was enacted only because of the determined, if somewhat surprising, efforts of Ronald Reagan, who had once described the progressive income tax as having come “direct from Karl Marx” (Reagan, 1961), and the leadership of Republican Senator Robert Packwood, Chairman of the Senate Finance Committee, and Democrat Dan Rostenkowski, Chairman of the House Ways and Means Committee.

The ink had hardly dried on the 1986 tax act before Democrats, most notably Speaker of the House Jim Wright of Texas, called for rate increases, and supply-side Republicans initiated tax incentives for savings and investments. In the two decades since 1986, Congress has amended the tax law annually, adding thousands of pages of new legislation to the Code. Six enactments were particularly important: 1) the Omnibus Budget Reconciliation Act of 1990 (the “1990 Budget Act”), a bipartisan deficit-reduction measure that broke George H. W. Bush’s famous “no new taxes pledge,” probably costing him reelection; 2) the Omnibus Budget Reconciliation Act of 1993 (the “1993 Act”), Bill Clinton’s rate-raising deficit reduction effort, which was enacted with only Democratic votes; 3) the Taxpayer Relief Act of 1997 (the “1997 Act”), a bipartisan tax-cutting law, most notable for cutting capital gains rates; 4) the Economic Growth and Tax Relief Reconciliation Act of 2001 (the “2001 Act”), a tax reduction measure fulfilling George W. Bush’s campaign promises to cut income tax rates and eliminate the estate tax; 5) the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the “2003 Act”), another George W. Bush tax cutting measure, most notable for lowering taxes on dividends and capital gains; 6) the American Jobs Creation Act of 2004 (the “2004 Act”), a corporate tax cut, responding in part to a decision of the World Trade Organization that had declared income tax benefits for exports illegal. These laws unraveled the 1986 reform by narrowing the corporate and individual income tax bases and raising the top individual income tax rate. The 1986 coalition of supply-side Republicans and tax-reforming Democrats has disintegrated. Republicans typically now favor low rates applied to a narrow base, while Democrats prefer higher rates on a different but also narrow base.

In retrospect, the inherent weaknesses of the 1986 Tax Reform Act have become easy to identify. First, the fragile political coalition that enacted the law left in place a variety of ongoing complexities, inequities, and inefficiencies. Second, the 1986 tax reform legislation had little public support even when it was passed. On June 25, 1986, the day after the Senate passed tax reform by a 97–3 vote, the *New York Times* reported that fewer than one-third of Americans believed that the Senate bill would produce a fairer tax system or reduce their own taxes (Clymer, 1986). Third, the revenue neutrality of the 1986 legislation failed to address the dominant fiscal policy issue of the day—the size of the federal deficit—which assured that many tax policy changes would soon become necessary. Fourth, the 1986 tax act was based on retaining and strengthening the income tax, rather than heeding the calls of many economists and politicians to replace it with some form of consumption tax. The internationalization of economic activity during the last two decades has

made the 1986 Act's reliance on increased taxation of income from capital and corporate income difficult to sustain.

Tax experts now regard the 1986 act as a promise failed. The public seems to agree, and considerable public support exists for a "flat tax" or a national sales tax to replace the income tax. Before turning to proposals for restructuring the nation's tax system, I shall examine the most important individual and corporate income tax changes since 1986.

Changes in the Individual Income Tax

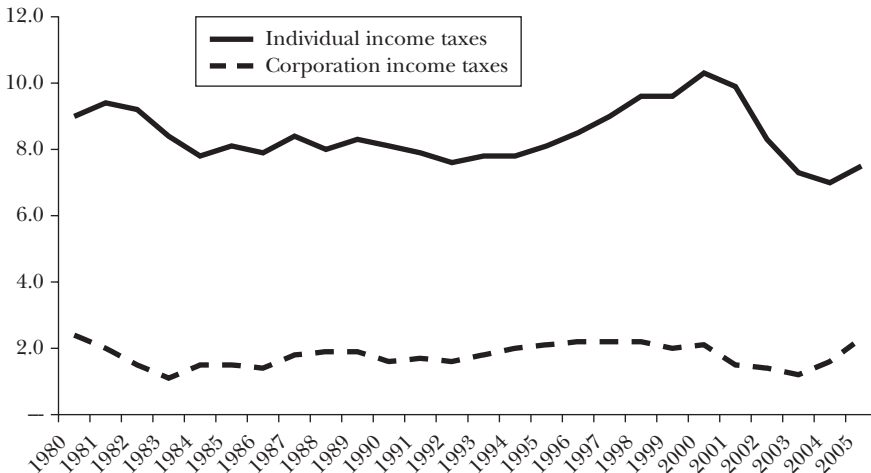
Despite all the changes to the tax code since 1986, the overall level of individual income taxes as a percentage of GDP has remained fairly steady, rising somewhat due to the tax increases and booming stock market of the late 1990s and falling after 2001 due to George W. Bush's tax cuts, as shown in Figure 1. However, legislative and economic developments have wrought important changes in the structure of the tax.

The EITC and Child Tax Credit

At the bottom of the income scale, the most important changes have involved the Earned Income Tax Credit (EITC) and child credits. The EITC was originally adopted in 1975. It provides a tax credit for low-income working parents. In 2003, for example, for a family with two children, the tax credit is worth 40 percent of income up to the first \$10,510 earned, so that the maximum credit was \$4,204. Then the amount of the tax credit does not increase as the family's income rises to approximately \$14,730, and the credit phases out as the family's income rises to roughly \$34,692 (IRS, 2005; Parisi and Hollenbeck, 2005). Moreover, the tax credit is "refundable," which means that when the credit is more than the income taxes that would have been owed—a common occurrence for a low-income family with children—then the amount of the credit is paid to the taxpayer. The rate of the credit and the income ranges at which it applies vary according to filing status and the number of children. Also, taxpayers with investment income greater than a specified amount are not eligible.

Back in 1975, 6.2 million taxpayers claimed \$1.25 billion of earned income tax credits (about \$4.3 billion in 2003 dollars). Then, the maximum credit was \$400 (\$1,350 in 2003 dollars), and the income level at which the EITC phased-out completely was \$8,000 (about \$27,350 in 2003 dollars). The 1990 Budget Act increased the credit somewhat, and the 1993 legislation substantially expanded it. In effect, the EITC was transformed in the 1990s from a relatively small adjustment in the progressivity of the tax system—intended mainly to offset Social Security taxes on low income workers—into a partial replacement for welfare. In 1978, the year Congress made the EITC permanent, about \$1.1 billion was refunded to working families, far less than the \$6.3 billion in cash grants paid by the main welfare program at that time, Aid for Families with Dependent Children (AFDC).

Figure 1
Federal Receipts as Percent of GDP



Source: *Budget of the United States Government, Fiscal Year 2007*, Historical Tables (2006, Table 2.3 pp. 33–34).

In 2003, nearly \$39 billion in earned income tax credits were claimed by more than 22 million taxpayers. Of that amount only about \$5 billion was used to offset taxes; \$34 billion was paid out directly as refunds. The \$39 billion of EITC was about twice the \$19.6 billion spent that year on AFDC's successor, Temporary Assistance for Needy Families (TANF). The EITC amount was also more than the \$35.1 billion spent on Supplemental Security Income (SSI), the program for the low-income elderly. In addition, welfare payments under TANF generally cannot be received for more than five years, but the EITC can be claimed annually by low-income workers without any time limit.

A second partially refundable credit, the Child Tax Credit, was enacted in 1997, providing a \$400 credit per child (rising to \$500 in 1999). The 2001 act increased the credit to \$1,000. (Like all of the 2001 tax act, the increase in the child credit is scheduled to terminate after 2010, when the law will revert to its pre-2001 status in the unlikely event that there is no further congressional action.) In 2003, child tax credits totaled nearly \$32 billion, with more than \$9 billion of that amount refunded to taxpayers who otherwise owed no income tax.

The 1986 tax reform had reaffirmed the principle, first established in 1969, that no income tax should be paid by people with incomes at or below the poverty level. The 1986 Act accomplished this result by increases in personal exemptions (an amount excluded from taxation for each person in a household) and the standard deduction (the fixed deduction taken by taxpayers who do not submit a list of itemized deductions). The EITC and child tax credits have dramatically changed the income tax. Most low-income workers and many moderate-income families now file income tax returns only to claim refunds. In 2005, for example, a

married couple with two children owed no income tax until their income reached \$41,000. In 2004, the poverty threshold for a family of four was \$19,157, about half the level at which income tax now applies (Esenwein, 2005). To illustrate the same point in another way, in 1987, 18.5 percent of the 103 million returns filed were nontaxable. In 2003, 23.3 percent of the 130.4 million returns filed were nontaxable (Parisi and Hollenbeck, 2005).

The transformation of the Internal Revenue Service from being solely a tax collector to also being a check writer has produced difficulties. In 2003, more than two-thirds of returns claiming the Earned Income Tax Credit were prepared by paid preparers, many of whom tempt their customers with expensive “refund-anticipation” loans. The National Taxpayer Advocate has singled out the EITC as the most troublesome complex provision of the tax code. Her call for major simplification was seconded by the President’s Panel on Tax Reform (2005). In an effort to combat erroneous EITC claims, the IRS shifted audit resources away from high-income taxpayers to low-income families, provoking much criticism.¹

Targeted Tax Breaks

Moving up the income scale, “targeted tax cuts”—that is, income tax reductions generally made available only to taxpayers with no more than a specified level of income—have reduced tax burdens while greatly increasing complexity. Each year’s federal budget is required to contain a list of “tax expenditures,” defined as all tax credits, deductions, or exclusions that deviate from a “normal” income tax. The largest tax expenditures are the employer payments for health insurance and retirement savings that are excluded from taxation, along with the provisions that allow payments for mortgage interest, charitable contributions, and state and local taxes to be deducted from taxable income. But the number of tax expenditures has multiplied in recent years. The president’s budget for fiscal year 2006 listed 146 total tax expenditures, of which 66—or 45 percent of the total—have been added since 1986. The estimated total costs of tax expenditures for individual income taxes declined from about \$500 billion in 1986 to about \$360 billion in 1988, following the 1986 tax reform, then rose to about \$685 billion in 2002 (all in 2004 dollars).

Historically, when competing policy ideas aimed at a common goal emerged in Congress, the leaders of the tax writing committees would fashion a compromise provision with the advice of the Department of the Treasury and the Chief of Staff of the Joint Committee on Taxation. Now, with the dispersion of power within the Congress and the proliferation and expansion of tax staffs, Congress often compromises by enacting all of the ideas, leaving unsophisticated taxpayers bewildered about how to cope. For a vivid illustration, consider incentives for paying for higher

¹ Also, the Earned Income Tax Credit imposes a large “marriage penalty” on low-income families. Imagine two low-income workers, with one or both eligible for the EITC. When they marry, their joint income becomes high enough that their EITC benefits after marriage are either much lower or nonexistent.

education. There are eight tax expenditures for current-year education expenses: two tax credits, three deductions, and three exclusions from income. Five other provisions promote savings for college expenses. In 1987, there were only three provisions encouraging college expenditures or savings. The 1997 Act alone added five provisions that were estimated to cost \$41 billion over five years, which together represent the largest increase in federal funding for higher education since the GI Bill (Jackson, 2006).

Comprehending the tax savings provided by these provisions, their various eligibility requirements, how they interact, and their recordkeeping and reporting requirements is mind-boggling. For example, the so-called HOPE credit provides a 100 percent nonrefundable tax credit for the first \$1,000 of post-secondary tuition and a 50 percent credit for the second \$1,000 of tuition and related expenses for the first two years of a student's undergraduate education. The Lifetime Learning credit provides a 20 percent credit for the first \$10,000 of a family's post-secondary education, including all undergraduate, graduate, and professional education. Both credits are reduced as income exceeds \$40,000 (\$80,000 for a married couple) and disappear for taxpayers with more than \$50,000 of income (\$100,000 for a married couple). Only one of these credits is available per year for the same student. Other overlapping provisions—which include limited deductions for tuition; savings incentives such as education Individual Retirement Accounts and qualified state tuition programs; exclusions from income for amounts used to pay for educational expenses (for example, interest on education savings bonds); and deductions for the costs of borrowing to pay for educational expenses—have different income limits.

Each of the provisions has its own eligibility criteria and definition of qualified expenses. For example, these rules do not provide consistent treatment with regard to room and board; books, supplies, and equipment; sports expenses; nonacademic fees; or the class of relatives whose expenses may be taken into account. A student convicted of a felony for possession or distribution of a controlled substance is not eligible for the HOPE credit, but such a conviction is no bar to the Lifetime Learning credit. If amounts distributed from an education IRA are excludable from income because they are used to pay the qualified higher education expenses of the beneficiary, neither the HOPE nor Lifetime Learning credit may be claimed for the same year with respect to the same individual. The individual may elect to forego the exclusion, in which case a HOPE or Lifetime learning credit may be claimed. The issues named here are just the tip of the iceberg.

Many people believe that tax incentives are enacted to reward campaign contributors or to satisfy lobbyists, and sometimes they are, but many of the complex provisions that now fill the tax code reflect congressional efforts to cater to the general public. Congressional Republicans will embrace almost any tax cut, and Democrats often view income tax benefits as the best way to achieve domestic policy goals otherwise blocked by political barriers or legal limitations on additional spending.

But relying on income tax breaks to rectify the nation's social and economic

problems often does not work especially well. The stream of tax breaks for education has not addressed the problems of cost control or access to colleges and universities. Financing America's health care system for working Americans primarily through a tax advantage for employers and employees, and more recently by adding tax breaks for health care savings accounts coupled with high-deductible health insurance, has left America with by far the highest health care costs in the world and more than 40 million Americans without insurance. Nevertheless, Congress and presidents, regardless of their political party, use income tax incentives the way my mother employed chicken soup—as a magic elixir for every conceivable ill. If the nation has a problem in access to education, child care affordability, health insurance coverage, retirement security, or the financing of long-term care, to name just a few, Congress hands out some income tax deductions or credits. The competition to give tax breaks for various expenditures has broken the income tax. Adding together both the money spent directly on tax preparers and the time spent preparing tax information, ordinary citizens and businesses incurred compliance costs of \$265 billion last year—22 cents for every dollar collected—to fulfill their tax obligations or to try to take advantage of provisions to reduce their income tax (Hodge et al., 2005).

The Alternative Minimum Tax

In the wake of the tax rate reductions of the 2001 Act, problems due to the alternative minimum tax (AMT) have taken center stage. Since 1969, the tax law has contained provisions intended to assure that all high-income taxpayers would pay at least a moderate amount of income tax. Since 1982, the minimum tax has taken the form of an alternative tax schedule with a broader tax base and lower rates than the regular tax: taxpayers are required to pay either the taxes they owe under the regular tax code or under the alternative minimum tax, whichever is higher. But over the last two decades, the regular and alternative tax codes have evolved so that a greater share of taxpayers find themselves needing to pay the alternative minimum tax.

Two key parameters in determining how many people will face greater tax liabilities under the alternative minimum tax are the level of income that is exempt under the alternative minimum tax and the tax rate applied above that level. In 1985, regular tax brackets and exemption amounts in the regular tax code began to be indexed for inflation, but the basic \$40,000 exemption in the alternative minimum tax has never been indexed, so its real value has declined over time. Then, the alternative minimum tax rate was 40 percent of the top marginal rate in the regular income tax. The 1986 Act lowered the regular tax rate and raised the alternative minimum tax rate from 20 to 21 percent, so that the alternative minimum tax rate became 75 percent of the top marginal tax rate. The 1990 Act increased the alternative minimum tax rates rate to 24 percent; the 1993 Act increased the exemption to \$45,000 and raised the alternative minimum tax rate again, adding a second bracket so it had two rates of 26 and 28 percent. When regular tax rates were reduced in 2001, alternative minimum tax rates were not

changed. As a result, the top alternative minimum tax rate is now 80 percent of the top individual rate. The 2001 Act increased the alternative minimum tax exemption to \$49,000 and the 2003 Act increased it to \$58,000. But these increases were all enacted on a temporary basis. And the alternative minimum tax also disallows a number of commonplace tax deductions, such as for personal exemptions for children and for state and local taxes.

Under current law, a larger share of taxpayers will become subject to the alternative minimum tax in the years ahead. In 2002, 1.4 percent of tax returns were subject to the alternative minimum tax; by 2010, 20 percent of all returns will be subject to the alternative minimum tax, and revenues collected through the alternative minimum tax will exceed those collected through the regular tax (Joint Committee on Taxation, 2005; Burman et al., 2003). The alternative minimum tax is burdensome to taxpayers as it requires them to calculate their taxes under two sets of rules and then pay whichever result is higher. Members of Congress, the staff of the Joint Committee on Taxation, and President Bush's 2005 Tax Reform Panel all have called for repeal of the alternative minimum tax; however, repeal is expensive. The President's Panel (2005), for example, estimated that repeal of the alternative minimum tax would cost \$1.2 trillion over a ten-year period if the 2001 and 2003 tax cuts are made permanent. If the alternative minimum tax expands its reach dramatically, as current law provides, the resulting public anger might stimulate major overhaul of the nation's tax system.

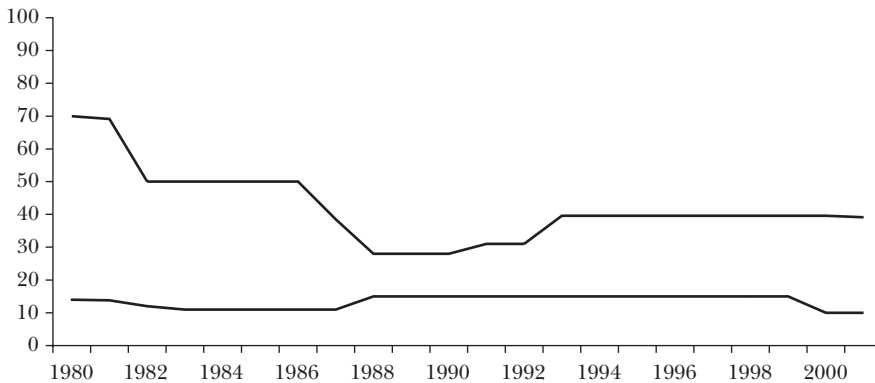
Top Rates and Capital Gains Rates

At the top end of the income distribution, the most significant legislative changes have involved revisions to the structure of tax rates and the taxation of capital gains and dividends. Recent decades have also seen a significant shift in the distribution of income toward the very top, which has affected the share of taxes paid by this group.

When Ronald Reagan took office in 1981, the top marginal income tax rate was 70 percent with a 50 percent maximum rate on "earned income," which is how the tax code generally refers to wage and salary income. His 1981 legislation dropped the top rate to 50 percent, and the 1986 Act further reduced it to 28 percent (although it also included a "bubble" rate of 33 percent that applied below the top income level, constructed so that the highest average tax rate never exceeded 28 percent). The first President Bush in 1990 agreed to eliminate this bubble and raise the top rate to 31 percent. In 1993 President Clinton raised the top rate to 39.6 percent. The 2001 act reversed field, phasing in a reduction in the top rate to 35 percent and eliminating two provisions enacted in 1990 (a phase-out at higher income levels of personal exemptions and a reduction of itemized deductions) that had surreptitiously increased the top rate beyond the statutory maximum. The highest and lowest statutory income tax rates over time are shown in Figure 2.

This reduction in top marginal tax rates has been accompanied by a greater share of income being concentrated at the top of the income distribution. In the

Figure 2

Highest and Lowest Marginal Income Tax Rates by Year

Source: Pechman (1987), updated with current IRS publications.

period between 1979 and 2002, the share of income received by the highest quintile rose substantially, while the shares of income of the four lowest quintiles declined. Most of the increase for the top quintile occurred at the very top of the income distribution. For example, the income share of the top 1 percent of the income distribution rose steadily from a low of 9.6 percent in 1979 to a high of 21.6 percent in 2000 before falling back to 16.9 percent in 2002. Indeed, the income share of the top 0.1 percent grew from 3.3 percent to 10.5 percent during this period. The amount of income needed to join this group more than quadrupled in nominal dollars from \$234,000 in 1979 to \$1,278,000 in 2002, and doubled in real dollars from \$321,679 to \$710,661 in constant 1982–1984 dollars (Strudler et al., 2004).

Capital gains, which are gains on an asset held over a period of time, always present a difficult question for the tax code. One theoretical answer is to tax capital gains as they accrue, even if the asset has not been sold, but this approach has long been a political dead letter. But otherwise, taxpayers will have some discretion about when to sell the asset and thus when to pay taxes. Advocates of lowering the capital gains rate claim that it will stimulate new investments, advance technology, trigger economic growth, and enhance democracy and freedom. With similar hyperbole, opponents of lower capital gains rates claim that taxing capital gains the same as ordinary income would eliminate tax shelters, dramatically simplify the law, and promote tax justice. Both sides' claims are overstated. Those with great wealth have always enjoyed great discretion about when to realize capital gains. Opportunities for high-income taxpayers to defer and avoid capital-gains taxes make high rates of tax unproductive. On the other hand, it is not at all clear that the revenue lost by taxing capital gains at 15 percent rather than 20 or 25 percent is compensated for by increased savings, investment, or economic growth.

Since 1921, capital gains had been taxed at a rate substantially lower than that on either earned income or other investment income. For example, during the

period 1942–1969, capital gains were taxed at a top rate of 25 percent while the highest rate on other income ranged as high as 91 percent. In the years immediately preceding the 1986 Act, the capital gains rate was 20 percent. The 1986 Act raised the capital gains rate to 28 percent, the same rate as for other income, which unleashed a torrent of gains realizations in late 1986—\$45.4 billion in December alone (Burman et al., 1994)—to take advantage of the 20 percent rate before the new rate took effect in January 1987. When George H. W. Bush assumed the presidency in 1989, he advocated lowering the capital gains rate to 15 percent, but the Democratic Congress thwarted him. However, the 1997 tax legislation signed by Bill Clinton reduced the capital gains rate to 20 percent. In 2003 Congress further lowered the capital gains rate to 15 percent.

Revenue and Distributional Tables

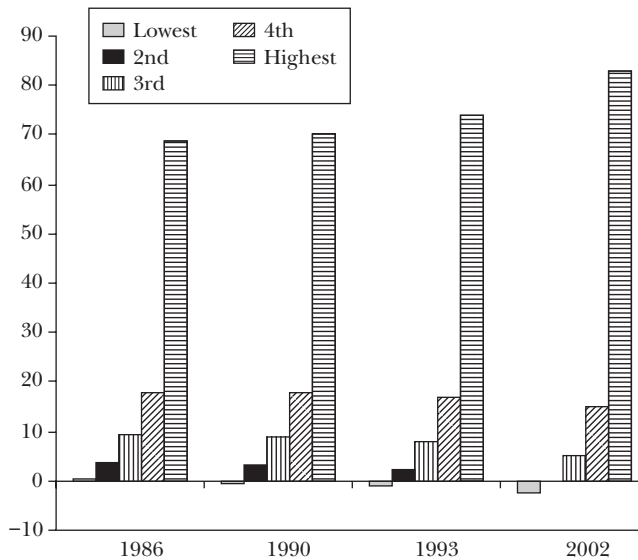
Revenue effects of tax legislation used to be estimated over a five-year “budget window”; that period is still sometimes five years but more often is ten years. Unsurprisingly, a fixed period has stimulated tricks and dodges to push revenue losses outside the “budget window.” One straightforward example is Congress’s shift from standard individual retirement accounts (IRAs), where contributions to the account are deductible from taxes when contributed and taxed when withdrawn, to so-called Roth IRAs, where no deduction is allowed for contributions but withdrawals are tax-free. Although these two types of IRA’s have similar present-value revenue effects, the Roth-type IRA postpones revenue costs until people retire and therefore appears much less expensive within a five or ten-year budget window. Other examples abound (Graetz, 1995).

In the 2001 and 2003 tax acts, revenue-estimating games reached new lows. Congress agreed to “limit” the overall size of the tax cuts to \$1.2 trillion in the 2001 Act and to \$350 billion in 2003 over their respective ten-year budget windows. However, Congress then enacted a host of tax cuts that would take effect in a few years and then terminate, which reduced their cost in the ten-year window. The entire 2001 tax act, for example, sunsets at the end of 2010—so it has no official budgetary costs after that date. After the laws were enacted, with George Bush taking the lead, Republicans immediately started working to accelerate many of the cuts and repeal the sunsets. The original budgetary limits set in 2001 and 2003 fell by the wayside. When proponents of repealing the termination provisions enacted in 2001 and 2003 say that they want to make the tax cuts “permanent” they mean they want to eliminate the sunsets scheduled to take effect. In tax policy, the law is never really permanent; the fat lady never sings.

This stop-and-start tax law created new difficulties for the public. How, for example, can one sensibly do estate-tax planning when the laws that govern the estate tax increase tax exemptions and reduce rates between 2001 and 2009, repeal the estate tax for 2010, and reinstate the pre-2001 rates and exemptions in 2011?

Estimates of the proposed changes on the distribution of tax burdens have also played a major role in shaping the tax legislation of the past two decades. They were, for example, at the forefront of the 1990 budget negotiations (Graetz, 1995;

Figure 3

Percent Share of Income Tax Liability by Quintile

Source: Internal Revenue Service, Tax Statistics, at (<http://www.irs.gov/taxstats/indtaxstats/article/0,,id=98123,00.html>).

1999). Similarly, President Bush's 2001 Act cut tax rates at both at the top and bottom of the income scale and child credits were increased significantly, so that taxes were reduced to some extent across the income distribution.

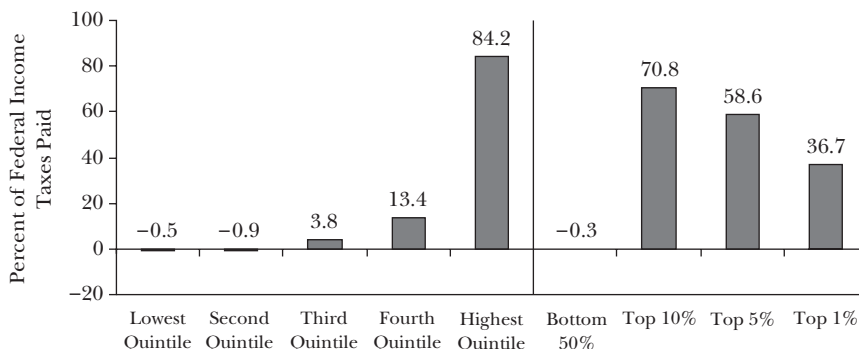
The changes in the taxing and distribution of income since 1986 have dramatically altered the structure of the income tax and its distribution of burdens. Figure 3 shows the share of income tax liability by quintile from 1986 to 2002. Figure 4 shows the distribution of the federal income tax burden in 2006. In the bottom two quintiles of the income distribution, the overall income tax is negative, because of the refundable earned income tax credit and child credits. For low-income taxpayers—indeed, for the four bottom quintiles—the payroll taxes that support Social Security and Medicare, but are not shown in the tables, are more burdensome than the income tax.

The income tax remains quite progressive, with about two-thirds of income tax now being paid by the top 10 percent of earners. However, it is difficult to determine in an airtight way whether the progressivity of the tax code has risen or fallen over time.² To be sure, the share of taxes paid by the highest-income group has risen. But the share of income received by that group has also risen quite substantially, which would raise their share of taxes even with no change in the tax

² Thomas Picketty and Emmanuel Saez (in this issue) claim that progressivity has declined dramatically since the 1960s.

Figure 4

Distribution of Federal Income Tax Burden under Current Law by Income Percentile, 2006



Source: U.S. Treasury, Office of Tax Analysis, reprinted from President's Panel on Tax Reform (2005, p. 33).

Note: Estimates are of 2006 law at 2006 cash income levels.

code at all. For example, the top 10 percent income group paid 55 percent of the total individual income tax in 1987 and 45.6 percent in 1988, while earning between 35 and 39 percent of all adjusted gross income in those years. In 2002, the top 10 percent (with adjusted gross income of at least \$92,663) earned 41.8 percent of adjusted gross income and paid 65.7 percent of the total individual income tax. Taxes paid by high-income taxpayers often vary considerably because there are better and worse times to realize capital gains, depending on changes in asset markets and the timing of changes in the tax code. Also, the tax cuts since 2001 have helped to generate large budget deficits. A full model for determining the progressivity of the tax code would need to take into account the distributional effects of how those budget deficits will be repaid over time. Nevertheless, the income tax remains quite progressive, with about two-thirds of its revenue coming from the highest 10 percent of earners.

The Corporate Income Tax

The 1986 Tax Reform Act managed to achieve a 28 percent top marginal rate for individuals and meet its goals of revenue and distributional neutrality by increasing the tax burden on corporations by \$120 billion in the years 1987 through 1991 (Joint Committee on Taxation, 1987). This outcome was politically possible because corporate interests split between capital-intensive companies that wanted favorable depreciation allowances, which would allow them to write off their large capital expenses quickly, and service companies more interested in lower corporate tax rates. The 1986 Act reversed the trend, spurred by the 1981 tax

cuts, of declining corporate taxes both as a share of federal revenues and of GDP (shown earlier in Figure 1). However, corporate income taxes, which are now about 2 percent of GDP, are not likely ever again to reach the levels of 4 to 5 percent of GDP that prevailed in the 1950s and even into the 1960s.

Since the Tax Reform Act of 1986, three important phenomena affecting the corporate income tax have been the rise of corporate tax shelters, the growing interest in the integration of corporate and individual income taxes, and the internationalization of the economy. I consider these three issues in turn.

Corporate Tax Shelters

The 1986 Tax Reform Act halted the proliferation of *individual* tax shelters by enacting limitations on deductions of “passive losses.” Specifically, these rules prohibited individuals from using “tax shelters”—investments in which they had no active managerial involvement but that were structured to create substantial losses on paper—to offset their income from earnings or investments. However, no similar solution has emerged to slow *corporate* tax shelters. In recent years, corporate tax shelters have reduced federal revenues by many billions of dollars and have undermined the public’s sense of tax fairness.

The corporate tax shelter phenomenon dates from at least the early 1980s, when Congress rewarded corporate tax planning by enacting “safe-harbor leasing,” a scheme that allowed corporations to sell their tax savings that were unusable because the firm’s tax bill had already been reduced to zero (such as from losses, depreciation of their capital investments, or foreign tax credits) to companies that could use them. The straightforward way to allow companies to capture the value of tax breaks they could not use would have been to refund taxes, but this would have smacked of “corporate welfare.” Congress preferred instead to permit companies to sell tax benefits amongst themselves. This “lease-a-deduction” scheme became an object of popular satire; for example, Dianne Bennett, a tax lawyer from Buffalo, New York, suggested that low- and moderate-income families should be able to “lease” a welfare family to obtain their children’s tax allowances (Clark, 1991). Only one’s imagination limits the possibilities for “leasing” tax breaks.

By 1986, when Congress eliminated safe-harbor leasing, corporate attitudes toward the income tax had changed. Many managers had come to regard their tax departments as another potential profit center. Corporations could increase shareholders’ returns by producing a better product, selling more goods or services, cutting costs, or reducing taxes. Tax savings were often the easiest.

A decade later, the character of corporate tax shelters had changed. Rather than transferring legitimate tax deductions to a corporation that could use them, corporate tax shelters frequently have no nontax economic substance at all. One common technique is to create a financial transaction with offsetting gains and losses, and have the losses allocated to a U.S. corporation while the gains are allocated to a taxpayer not subject to U.S. income taxation. Often, these “tax indifferent” parties are foreign financial institutions.

Most efforts to address the corporate tax shelter problem have involved greater

disclosures of tax-shelter transactions and greater penalties on those who enter into them. It is easy to define a tax shelter in general terms: tax shelters are deals done by very smart people that, absent tax considerations, would be very stupid. But translating this definition into legislative language to attack tax shelters or to justify enhanced penalties is far more difficult. To be effective, any attack on corporate tax shelters must change the incentives for corporate management to enter into such transactions. Many companies are willing to take the chance that tax shelter transactions either will not be discovered by the IRS or, if discovered, that a court will uphold the taxpayer's view of the facts and the law. No natural counterforce exists to offset the potential benefits a company might win by playing what is, effectively, a tax audit lottery.

In fact, as Desai (2005) recently explained in this journal, companies keep two different sets of books, one for tax purposes and one for reporting to shareholders. Thus, corporate tax-shelter deductions, credits, and losses reduce tax liability without also reducing the income reported on the company's financial statements to shareholders. In this way, tax shelters give a company the best of both worlds: lower taxes are paid to the government while higher profits are reported to shareholders. In the 1986 Act, Congress linked the two different corporate income statements, one for shareholders and one for taxes, in a corporate alternative minimum tax, but this linkage expired after three years. The IRS recently expanded its required disclosures of these disparities, but a stable solution to the corporate tax-shelter problem may well require greater conformity between book and tax accounting for publicly traded companies.

Integration of the Corporate and Individual Taxes

Integration of corporate and individual income taxes—so that corporate income would be taxed only once at either the corporate or shareholder level, rather than both when earned by the corporation and again when distributed as a dividend—has recently attracted significant attention. Important studies were produced by the U.S. Department of the Treasury (1992) and the American Law Institute (Warren, 1993; Graetz and Warren, 1998). One major option is to provide shareholders with a credit for any corporate taxes paid on dividends received. In this approach, corporate income is ultimately taxed only once at the shareholder's tax rate. The other major policy option for integrating corporate and shareholder taxes is full or partial shareholder dividend exclusion—that is, profits paid out as dividends are taxed at the corporate level, but would be excluded from taxation at the shareholder level.³ Until quite recently, many European countries limited double taxation of corporate income by providing full or partial shareholder credits for corporate taxes paid with respect to income distributed as a dividend. But after a series of decisions by the European Court of Justice holding that

³ A third option, deduction of dividends, is usually rejected because it would automatically extend the benefits of corporate and individual income tax integration to foreign shareholders and exempt shareholders.

shareholder credit systems violate the free movement of capital guaranteed by the European Treaties, many European nations have replaced their shareholder credit systems with partial shareholder exclusions of dividends (Vann, 2003).

In 2003, President Bush urged Congress to exclude from shareholders' income dividends paid out of corporate income that already had been subject to U.S. corporate level tax—a proposal modeled after a 1992 U.S. Treasury report. Congress instead provided a 15 percent rate for dividends regardless of whether the income had been previously taxed at the corporate level. At the same time, also in the name of reducing the double taxation of corporate income, Congress reduced the capital gains rate to 15 percent, but without regard to whether the gains are attributable to retained earnings taxed at the corporate level. The current state of affairs does not seem stable. Many Democrats have since urged a return to higher rates on both dividends and capital gains. Others, including the President's Tax Reform Panel (2005), have urged complete elimination of double taxes, at least for dividends paid by U.S. companies.

Internationalization

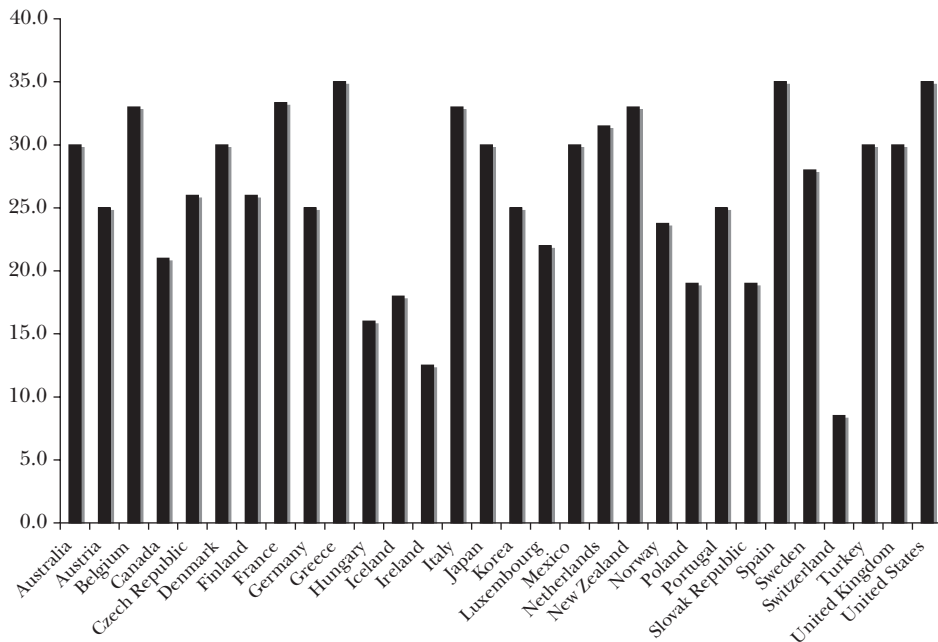
Flows of direct and portfolio investments into and out of the United States have increased dramatically since 1986. In 1986, foreign-owned assets in the U.S. economy totaled \$1.5 trillion (measured at market value), while U.S.-owned assets abroad were \$1.6 trillion. By 2004, foreign-owned assets in the U.S. economy climbed to \$12.5 trillion, while U.S.-owned assets abroad had reached \$10.0 trillion (U.S. Bureau of Economic Analysis, <http://www.bea.gov/bea/di/home/iip.htm>), accessed May 12, 2006). Foreign financial and global trading centers offering favorable tax treatment are now commonplace. These developments, along with a range of new financial instruments and technologies, pose striking challenges for corporate income taxation. The United States, like other countries, has long wanted to avoid situations in which corporate income earned abroad is taxed both by a foreign country and by the U.S. government, but the United States also doesn't want American firms to shift income to related foreign companies to reduce taxes on their income earned in the United States.

In the Tax Reform Act of 1986, Congress was primarily concerned with limiting benefits for income earned abroad. The legislation, for example, classified foreign income into nine separate baskets for determining eligibility for foreign tax credits, thereby restricting the ability of companies to offset U.S. taxes with foreign taxes on unrelated income. The 1986 Act also limited interest deductions for companies that invest abroad.

It is common for U.S. subsidiaries of foreign companies to overpay their foreign parents for intangible assets, shifting income abroad. This outcome also occurs when U.S. companies shift income to low-taxed foreign subsidiaries. During the 1990s, in an effort to curtail such practices, the U.S. Treasury substantially revised its transfer-pricing regulations and the IRS initiated advance pricing agreements with companies and other nations.

Many OECD nations have responded to the increasing internationalization of

Figure 5

Top Corporate Tax Rates in the OECD, 2005

Source: OECD Tax Database, available at http://www.oecd.org/document/60/0,2340,en_2649_34533_1942460_1_1_1_1,00.html.

business by reducing their corporate tax rates and broadening their corporate tax bases (CBO, 2005; Sullivan, 2006). After the 1986 Act, the U.S. corporate tax rate was one of the lowest among the OECD nations. Now, as shown in Figure 5, it is one of the highest.⁴

The internationalization of business has effectively capped the role of corporate income taxes as a source of federal revenue. Very little U.S. tax revenue is now being collected from foreign-source business income.⁵ The thrust of the 1986 legislation—toward tightening income-tax rules for foreign investments by U.S. companies—has been reversed. Nations today want low corporate income taxes both to attract domestic investments and to reduce the temptation for domestic companies to shift income abroad. Although President Clinton in 1993 got a

⁴ Figure 5 does not include subnational taxes; including these would increase the rates of the United States and a few other countries, notably Canada, Germany, and Japan.

⁵ Both the Joint Committee on Taxation and the President's Tax Reform Panel (2005) have urged replacing the U.S. foreign tax credit with an exemption for dividends paid out of foreign source business income. Depending on how royalties and certain business deductions are treated, such a change might increase U. S. corporate revenues, a fact that demonstrates how little tax revenue is being collected from foreign-source income. I have elsewhere urged an exemption for dividends paid from foreign-source active business income (Graetz, 2001).

one-percentage-point increase in the corporate tax rate (from 34 to 35 percent) through Congress, it now seems far more likely that U.S. corporate rates will decrease in the years ahead. The 2004 Act substantially liberalized both the foreign tax credit and interest deduction limitations enacted in 1986. In 2004, Congress also created a special lower corporate tax rate for income from domestic manufacturing activities, thus reducing the tax savings from taking manufacturing abroad.

Increasing taxes on corporations may be as popular with the public now as in 1986, but it is far less feasible economically. There is a need for a fundamental reexamination of U.S. international income tax policies. Otherwise, the combination of sophisticated corporate tax planning and tax competition among nations to attract investments may cause the taxation of international corporate income to unravel completely.

A Look Ahead

The Tax Reform Act of 1986 has not proved a stable outcome: Congress has since narrowed the tax base and raised income tax rates. Internationalization of the economy raises the question of whether corporate income taxes can be relied upon as a stable source of revenues. Moreover, the tax system is also under continual reexamination because federal deficits of \$300–\$400 billion a year are now commonplace and, in the coming decades, an aging population and rising health care costs will put great additional pressures on the budgets of both federal and state governments. The challenge of tax reform is to create and maintain a tax system that produces adequate revenues in a simpler, fairer, and more economically efficient manner.

The complexities, inequities, and inefficiencies of the current income tax have led many analysts and more than a few politicians to call for replacing all or a substantial part of the income tax with some form of consumption tax. Considerable disagreement, however, exists over the best structure and role for a consumption tax. The alternative with the most cosponsors in Congress is a national sales tax. But to replace the revenue of the income tax, a national sales tax would need to have a rate in the range of 30 percent (Boortz and Linder, 2005; Slemrod, 2005), depending on which goods and services are exempt from the sales tax. This rate would be much higher than any sales tax in the world and would create strong incentives for evasion. The main alternative to the income tax recommended by the President's Advisory Panel on Tax Reform (2005) is the so-called Growth and Investment Tax; which is a cousin of the "flat tax" proposed by Hall and Rabushka (1995) and also similar to the "X" tax proposed by Bradford (2005). These taxes are consumption taxes, variations on more common types of value-added taxes (VAT). However, unlike the common VAT, they tax wages and salary (but not the return on investments) at the individual level, and they can include personal exemptions or progressive tax rates as desired. The Growth and Investment Tax would tax wages at progressive rates up to 30 percent and all dividends, capital gains, and

interest income at 15 percent. This tax would deny deductions for interest paid; allow businesses to treat all money spent on capital investments as an immediate expense (rather than depreciating it over time); and exclude the financial income of “nonfinancial” corporations from tax. “Financial institutions” would be taxed on a cash-flow basis. The President’s Panel (2005) describes this tax as equivalent to a 30 percent credit-method value-added tax (a rate higher than in Europe or the rest of the OECD) coupled with a progressive system of wage subsidies and a separate single-rate tax on capital income.

The proposed Growth and Investment Tax represents some compromises made with an eye to political realities. For example, I agree with the panel’s judgment that taxing people only on wages will not fly politically. But even so, a tax reform along these lines is not a practical alternative. First, many U.S. businesses will not relish giving up their interest deductions in exchange for immediate expensing of investments and exclusion of financial income from taxation. Second, as the panel recognized, special rules are needed for financial institutions, raising line-drawing difficulties that may prove insuperable in an economy where banks are no longer completely walled off from other firms. Third, when the panel tacked a 15 percent tax on individual income from investments onto a consumption tax, it created significant incentives to shift investment income to a business, and offended consumption tax advocates. Fourth, the panel used a gimmick—shifting regular IRAs and other retirement savings into Roth-type IRAs—to push costs outside the budget window, so that the “revenue neutral” rate for the Growth and Investment Tax could be held to 30 percent. Finally, and most importantly, the panel admits that the Growth and Investment Tax violates both the General Agreement on Tariffs and Trade (GATT) and all 86 of America’s existing bilateral income tax treaties.

As its principal alternative to the Growth and Investment Tax, the President’s Panel recommended a 1986-style reform of the income tax. The main benefit of that plan would be the repeal of the alternative minimum tax; other benefits, like reducing the top-rate individual income tax rate by two percentage points to 33 percent are comparatively minor. To pay for these changes, the Panel found it necessary to attack a number of political sacred cows, such as the deductions for mortgage interest and for state and local taxes. Ultimately, the proposal is politically unviable: it trades immediate and painful base broadening for only trivial rate reductions and the avoidance of a future pain—the alternative minimum tax. The impact of the alternative minimum tax will not be felt by most people for several years.

Whatever the merits of the 1986 Tax Reform Act when it was enacted, it is neither practical nor desirable to reattempt to fix the income tax through a tradeoff involving base-broadening and rate reductions. The fundamental problem is that in a global economy, the United States can no longer afford to rely so heavily on income taxation to finance federal expenditures.

It is puzzling that U.S. economists and policymakers have struggled to fashion novel consumption tax alternatives, like a national sales tax or the Growth and Investment Tax, when there is a well-functioning consumption tax—the value-

added tax—being used throughout the OECD and in nearly 150 countries worldwide. The value-added tax works by collecting a tax on value-added at each stage of production. At each stage of production, firms can subtract the value-added tax that they paid to their suppliers from the value-added tax they must collect when they sell their goods and services. Since the value-added tax is collected from firms whose records can be used to check each other, it has proven to be an effective and relatively efficient method for collecting taxes throughout the world.

It is quite practical to create a combination of a value-added tax and an income tax that is roughly as progressive as current law and also revenue neutral, as in Graetz (1999) and (2002). This plan would return the income tax to its pre-World War II status—a much simpler low-rate tax on a relatively thin slice of higher-income Americans—and replace the lost revenue with a value-added tax. For example, a value-added tax in the range of 10 to 14 percent would finance an income tax system where no family pays any tax on its first \$100,000 in earned income, with a marginal rate of no more than 25 percent to be applied to individual incomes over \$100,000. A 15 to 20 percent income tax would apply to corporations. Of course, if the tax base was broadened along the lines proposed by the President's Panel (2005), then these tax rates could be even lower. A revised version of the Earned Income Tax Credit could be used to protect low- and moderate-income families from any tax increase. If payroll withholding was appropriately adjusted, this system could allow the elimination of low- and middle-income tax returns, freeing about 150 million people from filing income tax returns. For most Americans, April 15 would then be just another day.

Using a value-added tax to replace much of the income tax has many advantages. A combined value-added tax and income tax system would make the United States quite similar to the average OECD country in terms of consumption taxes relative to GDP as well as tax rates on consumption. The U.S. income tax, however, would be much smaller than what people generally face abroad. In 2002, the U.S. individual and corporate income taxes were about 12 percent of GDP, compared to an OECD average of about 13 percent and a European average of about 14 percent for income taxes. My plan in which a value-added tax replaces much of the income tax would reduce the U.S. income tax to just over 4 percent of GDP.

This tax system would be far more encouraging to savings and economic growth. Most Americans would owe no tax on their savings, and every American would face lower taxes on savings and investment. The United States would be a more attractive place for corporate investments. Moreover, this plan avoids the difficult issues of making a transition to an untried tax system, like the Growth and Investment Tax. It fits well within existing international tax and trade agreements. A dramatic reform like a mixture of value-added tax and income tax could redeem the failed promise of the Tax Reform Act of 1986.

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